No. 10697

In the United States Circuit Court of Appeals for the Ninth Circuit

AMELIA DAVIS BLOCH, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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CITATIONS

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OPINION BELOW

The memorandum opinion of the Tax Court (R. 46–50) is not officially reported.

JURISDICTION

This case involves federal income tax for the calendar year 1940. On May 26, 1942, the Commissioner of Internal Revenue mailed to the taxpayer notice of a deficiency in tax for 1940 in the amount of $1,-035.53. (R. 10–15.) Within 90 days thereafter and on August 21, 1942, the taxpayer filed a petition with the Tax Court (then the Board of Tax Appeals) for a redetermination of the deficiency under the provisions of Section 272 of the Internal Revenue Code. (R. 3–15.) The decision of the Tax Court finding a deficiency in income tax of $932.75 for 1940 was entered October 5, 1943. (R. 52.) The case is brought to this Court by a petition for review filed January 3, 1944 (R. 52–57), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

QUESTION PRESENTED

Whether under Section 113(a)(6) of the Internal Revenue Code the basis of shares of stock of Dow Chemical Company, sold by taxpayer in 1940, is properly determined by averaging the taxpayer's cost of shares of another corporation which taxpayer had previously exchanged for the Dow stock in a tax-free reorganization.

STATUTE INVOLVED

Internal Revenue Code:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * *

(b) *Exchanges Solely in Kind.*—

* * * * *

(3) *Stock for stock on reorganization.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corportion a party to the reorganization.

* * * * *

(g) *Definition of Reorganization.*—As used in this section and section 113—

(1) The term "reorganization" means (a) a statutory merger or consolidation, * * *

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

*   *   *   *   *

(26 U. S. C. 1940 ed., Sec. 112)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

*   *   *   *   *

(6) *Tax-free exchanges generally.*—If the property was acquired, after February 28, 1913, upon an exchange described in section 112 (b) to (e), inclusive, the basis (except as provided in paragraphs (15), (17), or (18) of this subsection) shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. * * *

*   *   *   *   *

(26 U. S. C. 1940 ed., Sec. 113)

The corresponding provisions of the Revenue Act of 1938, c. 289, 52 Stat. 447, are identical.

STATEMENT

The facts were stipulated (R. 18–40) and may be summarized as follows:

During the years 1923 to 1938, inclusive, the taxpayer acquired at various times by purchase and through a recapitalization shares of preferred and common stock in Great Western Electro-Chemical Company (hereinafter referred to as "Great Western"). (R. 18–20.) Immediately prior to December 31, 1938, the taxpayer's stockholdings and costs thereof in Great Western were as follows (R. 18–20):

Stock	Certificate No.	Number of shares	Cost
6% Preferred; Par Value $20	P 392–398 (for 100 shares each)	700	$11,025.00
	PL 145	95	
	PL 414	70	1,583.75
Common; No Par Value	273–274 (for 100 shares each)	200	2,300.00
	L 261	30	
	L 1178	20	1,006.00
	Total cost		$15,914.75

By agreement of statutory merger dated November 19, 1938 (R. 23–35), it was provided that Great Western should be merged with the Dow Chemical Company, the merger to be effective when approved by the stockholders of each corporation and when the formalities required by statute for merger had been performed (R. 25–27, 33). Upon the effective date of the agreement each share of Great Western preferred stock was to constitute and be converted into three-sixteenths of a share of no par value common stock of Dow, and each share of Great Western common stock was to constitute and be converted into one share of no par value common stock of Dow. (R. 28–29.) It was provided that Dow would issue its certificates in exchange for Great Western stock on this basis, but that stockholders of Great Western who did not approve of the merger might demand the fair market value of their shares as provided by law. (R. 29.) It was further provided that upon the effective date of the agreement all of Great Western's property, rights, privileges, powers, and franchises, would henceforth be vested in Dow. (R. 31–32.)

On or before December 31, 1938, the merger of Great Western with Dow became effective (R. 21) and on January 11, 1939, Dow notified the shareholders of Great Western that they were entitled to receive certificates of Dow stock in the agreed ratio upon surrender for cancellation of the certificates representing their Great Western shares (R. 39–40).

On January 24, 1939, taxpayer forwarded all her Great Western certificates to the transfer agent, who cancelled them and issued to her certificates representing 162$\frac{3}{16}$ shares of Dow stock in lieu of of the certificates for 865 shares of Great Western preferred stock; and certificates representing 250 shares of Dow stock in lieu of the certificates for 250 shares of Great Western common stock.[1] (R. 22.)

In March, 1940, taxpayer sold 212 shares of the Dow stock for a total selling price of $33,264.24. (R. 22.) The Tax Court found that the taxpayer's cost of the Great Western shares represented by the 212 shares of Dow stock sold was $13,900.17. She used this cost basis in determining the capital gain on the sale. (R. 47.)

[1] In the case of the common stock two certificates for 100 shares each of Dow stock were issued in lieu of two certificates for 100 shares each of Great Western and one certificate for 50 Dow shares was issued in lieu of two certificates for 30 and 20 shares, respectively, of Great Western common. (R. 22.)

In his deficiency notice the Commissioner determined that the taxpayer's cost of the 212 shares sold in 1940 was $8,185.32 and asserted a deficiency based in part on the increased capital gain on the sale resulting from this determination. (R. 12–13.) The Commissioner computed the $8,185.32 cost of the 212 shares by dividing the taxpayer's total cost of all Great Western shares acquired at different times and different prices by the total number of Dow shares received in exchange to get the cost per share, and then multiplying that amount by 212, the number of shares sold. (R. 47.) The Tax Court approved the Commissioner's determination of the cost basis.[2] (R. 50.)

SUMMARY OF ARGUMENT

Section 113 (a) (6) of the Internal Revenue Code provides that the cost basis of the shares of Dow Chemical Company acquired by taxpayer in a tax-free reorganization shall be the same as the Great Western stock for which they were exchanged. The Tax Court's holding that that basis under this statute is to be computed by averaging the cost of all the Great Western shares over the Dow shares acquired in exchange is correct. This method gives effect to reality. The Dow shares were all received at one time in one exchange and represent an equivalent

[2] The Tax Court consolidated the cases of taxpayer and her husband, involving the same question, for hearing and its opinion deals with both taxpayers. (R. 46–50.) It has been stipulated in this Court (R. 66–67) that the case of Louis Bloch shall be controlled by the final decision in the instant case.

interest in the new company. Each Dow share was received in exchange for the same number or numbers of Great Western shares, regardless of what the Great Western shares had cost the taxpayer. Consequently the assignment of an equal basis to each new Dow share conforms to the facts, and this is true whether the exchange of stock be considered voluntary or involuntary. The fact that stock of two corporations is involved in this case distinguishes it from cases involving stock split-ups in the same corporation, wherein it is held that the first-in, first-out rule is relevant for computing the basis of new shares.

The contention that each share of Great Western stock was separately exchanged for a share, or fraction of a share, of Dow stock is not supported by the merger agreement or by local law. Nor does Section 113 (a) (6) require that the transaction be viewed as a separate exchange of each Dow share for each Great Western share.

Under the rationale of the average method of determining the basis of stock in a new company, it is immaterial whether shares of the new stock can be identified with particular shares of stock of the old company. But in any event there has been no identification in this case. Each Dow share was exactly like every other Dow share and was indistinguishable from the others. Consequently it was impossible when they were all exchanged at one time to identify any Dow share with any Great Western share. The pairing up of certificate numbers is only an arbitrary

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device, not resting on any factual basis of identity, and fails to identify the shares represented by the certificates so matched.

In the present case, however, there was no pairing of particular certificate numbers in the case of the Dow shares issued in lieu of Great Western preferred shares, and hence no identification between those shares even through the device of matching. Although certificates were paired in the case of the Dow shares issued in lieu of the Great Western common shares, this was not shown to have been with intent to identify the shares represented by the certificates, and hence is without significance. But even if this arbitrary matching of certificates is held to constitute identification, there was at most identification of only a part of the Dow shares sold in 1940. The average cost rule must be used to compute the basis of shares not identified and should be used for all the shares, rather than a hybrid system of computing basis by two methods.

Nor has identification been made in this case by showing that the old and new shares were identical. The Dow shares represented interests in a new corporation possessing far greater assets than did the old corporation, and consequently they were not identical with the old shares. Further, although the exchange of stock was not made on a separate share for share basis as taxpayer contends, even if it had been so made, there is no evidence by which a particular share of new stock can be identified with a particular share of old stock.

ARGUMENT

Taxpayer's cost of the shares of stock of Dow Chemical Company is properly determined by the average cost method

The sole question in this case concerns the method by which the cost basis of the 212 shares of Dow stock sold by taxpayer in 1940 is to be determined. The shares sold were a part of the 412 3/16 shares of Dow stock acquired by taxpayer in exchange for all her stock in Great Western. It is not disputed that the exchange took place in connection with a statutory merger of Great Western and Dow and that this constituted a reorganization as defined in Section 112 (g) of the Revenue Act of 1938 and the Internal Revenue Code, *supra,* on which no gain or loss was recognized under Section 112 (b) (3) of the statute.[3] In such circumstances, Section 113 (a) (6) of the Internal Revenue Code, *supra,* provides that the basis of the property acquired—

> shall be the same as in the case of the property exchanged.

Thus, under the statute the 412 3/16 shares of Dow stock acquired in the reorganization must take the cost basis of the Great Western stock surrendered in exchange therefor, or $15,914.75. But since only 212 of the 412 3/16 shares were sold in 1940, the question arises as to what portion of the total cost of $15,914.75 is to be allocated to the 212 shares sold.

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[3] The provisions of the Revenue Act of 1938 control the year 1938, during which the merger occurred. The provisions of the Internal Revenue Code control the year 1939, during which the exchange of stock certificates was made. However, the sections of the two statutes which are involved in this case are identical in text.

The taxpayer contends that she has identified the Dow shares sold with particular shares of Great Western stock surrendered in exchange and that the basis of these Great Western shares carries over to the Dow shares. We contend that the Tax Court correctly held (R. 48–50) that the cost of the Dow shares sold in 1940 must be determined by the average cost method, regardless of whether the Dow shares were identified with any Great Western shares. We contend further that, in any event, no identification of the shares sold in 1940 was made.

1. The basis is determined by the average cost method irrespective of identification

It is apparent that the cost of a particular block or share of stock is difficult to determine when the owner of the stock has acquired a number of shares of that stock, all exactly alike except that they were acquired at different times and at different costs. In order to meet this difficulty, the Treasury in a long standing regulation [4] ruled that—

> If shares of stock in a corporation are sold from lots purchased at different dates or at different prices and the identity of the lots cannot be determined, the stock sold shall be charged against the earliest purchases of such stock.

See Treasury Regulations 103, promulgated under the Internal Revenue Code, Section 19.22 (a)–8. This is the familiar "first-in, first-out" rule, and it is to

[4] The regulation was first adopted in Article 4, paragraph 60, of Treasury Regulations 33 (Revised), promulgated under the Revenue Acts of 1916 and 1917.

be noted that it in terms applies only to purchases and sales of stock of a single corporation.

Nevertheless, the Commissioner sought to apply the first-in, first-out rule to cases wherein the original blocks of stock were exchanged for new stock in a tax-free reorganization. The courts, however, refused to apply the first-in, first-out rule in such circumstances. Commencing with *Commissioner* v. *Von Gunten,* 76 F. 2d 670 (C. C. A. 6th), it has been uniformly held that because shares received in a tax-free reorganization are shares in a new company which have all been received in one single transaction of exchange and for a single consideration, the shares of the old corporation, and because no particular share of the new stock acquired in this way represents any particular share of the old stock, the cost of the new shares is to be determined by dividing the total cost of all the old stock by the number of shares of the new stock. *Commissioner* v. *Stifel,* 75 F. 2d 583 (C. C. A. 4th); *Commissioner* v. *Oliver,* 78 F. 2d 561 (C. C. A. 3d); *Commissioner* v. *Bolender,* 82 F. 2d 591 (C. C. A. 7th); *Walker* v. *Commissioner,* 35 B. T. A. 640; *Epstein* v. *Commissioner,* 36 B. T. A. 109; *Runkle* v. *Commissioner,* 39 B. T. A. 458; *Fleischmann* v. *Commissioner,* 40 B. T. A. 672; *Mehan* v. *United States* (W. D. Mo.), decided September 3, 1937 (20 A. F. T. R. 1344).

There is some indication in the earlier cases cited that the use of the average cost method might not be proper if it were possible to identify particular new shares as having been exchanged for particular old shares and in such case that the actual cost of the given block of shares of the old company might then be employed.[5] But in *Arrott* v. *Commissioner,* 136 F. 2d 449 (C. C. A. 3d), the court squarely held that where stock in a new company is acquired in exchange for stock in an old company in a tax-free reorganization, the average cost method is the only permissible rule for determining the cost of the new shares, regardless of whether identification of the new shares with the old is possible. It said (p. 452):

> We think it [the average cost rule] is the only sound rule. The old shares all have the same exchange value for the new ones no matter what they cost the taxpayer. He gets as much new stock for the share for which he paid $80 as he does for the share for which he paid $120. The old shares lose their identity when traded for the new, just as the money with which one buys a war bond loses its identity in the certificate, though to the purchaser some of it may have been a gift, some won on a horse race and the remainder earned by the sweat of his brow. The old shares are gone; the new shares in what is at least nominally a new company takes their place. Each new share costs the taxpayer the quotient of the sum of the cost of the old shares divided by the number of new shares he receives.

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[5] It is significant, however, that in none of the cases considering the method of computing the basis of new shares exchanged for old in a reorganization has it been held that there was identification of the new shares with the old. And it will be developed, *infra*, that there was no identification in this case.

> If this is correct, the question of identification drops out of the operative facts in determining the value of shares received in a tax free reorganization. If it be thought to go too far, and identification of new shares received for specified old ones is legally relevant, it will not help the taxpayer here for there is no identification.

See also *Fleischmann* v. *Commissioner, supra,* where the Board of Tax Appeals indicated that even if it were possible to identify specific new shares with specific old shares, the application of the average cost method would not be avoided.

This rule is consistent with reality. After the merger the taxpayer had a certain number of Dow shares, received all at one time in exchange for her Great Western shares. Each share of each class of Great Western stock obtained for taxpayer the same share in the Dow enterprise, regardless of what that Great Western share had cost her. The only rational method then is to compute the cost of the Dow shares on an average basis. To assign different bases to shares which have the same value, represent equivalent interests, and were all acquired at one time would achieve an arbitrary, unreasonable, and unreal result.

The unreality is emphasized by the results obtained in this case under the two methods of computing basis. The total cost basis of the 412$^3/_{16}$ shares of Dow stock was \$15,914.75. Under the taxpayer's method a cost basis of \$13,900.17 is assigned to 212 of those shares (an average of about \$65.57), leaving only \$2,014.58 as the basis of the remaining 200³⁄₁₆ shares (an average of about \$10). Certainly it is arbitrary to say that, of a block of shares acquired in one transaction for one consideration, one-half have a basis of \$65.57 and the other half one of \$10. How much more reasonable it is to spread the consideration over all the shares equally, as is done by the average cost method, resulting in a uniform basis for all the shares of \$38.61. (See R. 13.)

Taxpayer seeks to avoid the effect of the *Arrott* case by arguing (Br. 18) that the average cost rule is not applicable to cases of involuntary exchanges, such as she contends was involved in her case. In none of the cases deciding that the average cost method is proper for determining the basis of shares acquired in a reorganization exchange was the holding made to depend on whether the exchange was voluntarily or involuntarily made; and the rationale of the average cost rule is applicable to any exchange of stock in one corporation for stock in another, irrespective of the reason for the exchange. But in any event, taxpayer erroneously asserts that the exchange was involuntary in her case. The right was preserved to her by the agreement of merger (R. 29) and by law (Sec. 369, Civil Code of California (1941)) to demand and receive the fair market value of her Great Western stock if she did not approve of the merger. Thus she had an option to participate in the reorganization or to receive the value of her stock, and her election to become a share holder in the new company precludes the exchange from being an involuntary one.

Taxpayer also contends (Br. 19–20) that her case is controlled by *Kraus* v. *Commissioner,* 88 F. 2d 616 (C. C. A. 2d), and *Fuller* v. *Commissioner,* 81 F. 2d 176 (C. C. A. 1st). In those cases it was held that in the case of new stock acquired in a recapitalization the average method of determining cost was not proper and that cost was to be determined by reference to the first-in, first-out rule unless there was identification of new shares with old shares, in which case the new shares were to take the basis of the old.[6] There, however, the stockholder merely received new stock in the *same corporation* by reason of a stock split-up or reduction of stock, a situation which falls within the scope of the first-in, first-out regulation. In the *Kraus* case it was specifically pointed out (p. 618) that the fact that the stock of only one corporation was involved was sufficient to distinguish that case from cases where the stock of a new corporation was acquired in exchange for the old stock. Since the taxpayer's case involves the stock of *two* corporations, it is similarly distinguishable from the *Kraus* and *Fuller* cases and is controlled by the *Arrott, Von Gunten,* and similar cases, holding that the average method is proper for determining basis.

Taxpayer's principal argument appears to be that under the agreement of merger each old share of Great Western stock was separately exchanged for

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[6] But see *contra Big Wolf Corp.* v. *Commissioner*, 2 T. C. 751, reviewed by the whole Tax Court, where the average method of determining the basis of new shares acquired in a recapitalization was held proper, since identification of the new shares was impossible.

each new share, or fraction thereof, of Dow stock (Br. 15–16) and hence (Br. 25–28) that Section 113 (a) (6) requires each new share to take the basis of each old share when identification between them has been established. This contention depends upon the identification of a specific new share with a particular old share, so that the actual cost of that new share may be known. It will be shown in the second division of this brief that taxpayer has not identified particular shares so that she must fail in this contention in any event. In the absence of specific identification, the actual cost of a particular share cannot be determined, and the average cost rule is the only method available by which the basis may be determined. But here it will be shown that the argument that each share was separately exchanged is without basis.[7]

It is true that the agreement of merger provides in Article III (R. 28–31) that on the effective date

[7] Taxpayer contends (Br. 16) that this Court is bound by local law to treat the transaction as though each share were separately exchanged. But taxpayer has not shown that local law regards the transaction as a series of separate exchanges. The statutes cited by her (Br. 12) contain no such provision, nor do *Copland* v. *Minong Mining Co.*, 33 Mich. 2, and *Ridgway* v. *Griswold*, Fed. Cases, No. 11819, so hold. Furthermore, even if the local law were as taxpayer contends, this is not a case where the federal courts would be bound thereby. The question here concerns the application of a taxing statute, whose operation is not dependent on state law. The exchange involved is factually essentially the same as other reorganization exchanges occurring in other states and must receive the same treatment under the federal basis statute, in order to give the statute uniform application. Cf. *Burnet* v. *Harmel*, 287 U. S. 103; *Burk-Waggoner Assn.* v. *Hopkins*, 269 U. S. 110.

of the merger the outstanding shares of Great Western are to constitute and be converted into Dow shares at fixed ratios (R. 28–29), but it does not provide that each share of old stock is to be separately exchanged for each share of new. On the contrary, it is clear that all shares are to be converted simultaneously on the date of the merger and the word "share" is used in the singular only to establish the rate of exchange. Certainly the conversion carried out in the exchange of certificates was not made share for share, but involved only one exchange, the shareholder's stock interest in the old corporation for his stock interest in the new.[8]

Section 113 (a) (6) does not provide that upon a single exchange of blocks of stock the basis of each new share shall be the same as that of the old. It provides only that the basis of property acquired on the exchange "shall be the same as in the case of the property exchanged." Consequently the provisions of the statute are served when the basis of all the

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[8] Although the point does not appear to be material in the argument we take issue with the taxpayer's contention (Br. 11–14) that the merger transaction can be broken down into two separate exchanges. It is a basic principle in reorganization cases that the transaction must be reviewed as a whole and not be separated into its component steps. *Case* v. *Commissioner*, 103 F. 2d 283, 286 (C. C. A. 9th); *Bassick* v. *Commissioner*, 85 F. 2d 8 (C. C. A. 2d), certiorari denied, 299 U. S. 592, rehearing denied, 299 U. S. 623. Applying this principle, it is clear that there was only one exchange of shares in this case. Even though the assenting stockholders of the old company may have acquired an interest in the assets of the new corporation on the date of the merger, the old certificates did not represent this interest and the exchange was completed when the certificates evidencing shares of the new company were issued.

new stock acquired at one time and for a single consideration is assigned the basis of all the old stock, as was done in the *Arrott* case and by the Tax Court in the instant case.

Thus, upon the authority of the *Arrott* case, we submit that the taxpayer's basis for the shares sold in 1940 is to be determined by the average cost method, and that it is irrelevant whether the shares sold were identified with any particular old shares. But even though the matter of identification be regarded as pertinent, in the following section of the argument it will be shown that the evidence in this case fails to identify the new shares with the old. There can be no question that, if there was no identification of the shares sold with any particular old shares, the average cost method is proper for determining taxpayer's basis for the shares sold. All the cases so hold. See *Commissioner* v. *Von Gunten,* 76 F. 2d 670 (C. C. A. 6th); *Commissioner* v. *Stifel,* 75 F. 2d 583 (C. C. A. 4th); *Commissioner* v. *Bolender,* 82 F. 2d 591 (C. C. A. 7th); and other cases cited above.

2. Taxpayer's evidence fails to identify the shares sold in 1940 with any old shares

The problem has frequently arisen of whether stock has been sufficiently identified so as to avoid the application of the first-in, first-out rule and it has been held that identity may be established not only by means of certificate numbers but also by reference to the cost or date of acquisition of the stock. See, for example, *Helvering* v. *Rankin,* 295 U. S. 123;

Davidson v. *Commissioner*, 305 U. S. 44; *Rule* v. *Commissioner*, 127 F. 2d 979 (C. C. A. 10th); *Curtis* v. *Helvering*, 101 F. 2d 40 (C. C. A. 2d); *Kraus* v. *Commissioner, supra; Fuller* v. *Commissioner, supra.* But all of these cases involve the means of identifying shares in *one corporation* only, which the taxpayer has acquired at different times and prices. In such case, if he disposes of shares represented by a certain certificate number and can show that he acquired the shares represented by that certificate for a certain cost, he has sufficiently identified the stock sold and may use that cost as his basis.

However, in no case, so far as we have found, where there has been an intervening exchange of stock in one company for stock in another, so that the stock of two corporations is involved, has it been held that identity between the old and new stock has been established. Although the opinion in the *Arrott* case assumes that identification may be possible although it was not established in that case, we submit that identification of new shares with any particular old shares is incompatible with the nature of a reorganization exchange and hence is impossible. In any event, there was no identification here.

In a reorganization a stockholder does not receive certain new shares in exchange for certain old shares and other new shares for other old shares. On the contrary, he surrender~~ed~~s all his shares in the old company and receives shares in the new company all at one time in a single transaction. The new shares are received as a unit for a single consideration, the stockholder's entire interest in the old corporation. All the old shares represented the same interest in the old corporation's assets but may be distinguished by reference to the time or the price of acquisition. Each share in the new corporation also represents the same interest in the assets of that corporation but since the new shares are all acquired at one time for one consideration there is no way in which they may be distinguished; each new share is exactly like every other new share. Consequently, it is impossible to identify any new share with any old share, except on a purely arbitrary basis. The attempt to identify shares through matching certificate numbers, when all the shares are exchanged at one time, is only an arbitrary device and fails of real identification. For example, suppose that 20 shares of stock in Corporation A, represented by Certificate 1 for 10 shares which cost \$100 and Certificate 2 for 10 shares which cost \$200, are exchanged at one time for 20 shares of stock in Corporation B represented by Certificates 1 and 2 for 10 shares each. There is no more reason for matching Certificate 1 of Corporation B with Certificate 1 of Corporation A than there is for matching Certificate 2 of Corporation B with Certificate 1 of Corporation A, since the B shares represented by the two certificates are all identical and all issued at one time. Even though Certificate 1 be matched with Certificate 1, this can represent only an arbitrary choice and is not the result of actually identifying the shares represented thereby.

This was the view taken in *Crespi* v. *Commissioner,* 126 F. 2d 699 (C. C. A. 5th). There the charter of a corporation had expired and a new corporation of the same name was formed to continue the same business. The taxpayer exchanged the stock held by him in the old corporation for an equivalent number of shares in the new corporation. Upon sale of some of the new shares, the court held that the cost basis for those shares must be computed by means of the average cost rule and not by using the cost basis of the old shares for which they were exchanged. This was true even though the corporation's records showed out of which old certificates the new certificates were issued, and each new certificate could be matched with the old certificate against which it was issued. The reasoning of the court was as follows (p. 701–702):

> When upon expiration of its charter the assets of the old corporation passed to its officers and directors as trustees, the full property in them passed to them as a whole, * * * When they were transferred to the new corporation the property was transferred, and had a value, as a whole, and when, to evidence the ownership of this value, shares in the new corporation were issued and distributed, each share represented an aliquot part of this value, and therefore each took the same basis as every other share.
>
> Despite therefore, the elaborate measures the taxpayer took to invest the new shares with the appearance of identity with the old, this was only appearance and it is not possible to affirm, as the taxpayer asks us to do, of a sale of shares in the new company, that the sale was not of an aliquot interest in that company as the owner

of all the properties of its predecessor, but was a sale of shares representing and in law the same as, particular shares purchased in the old company.

Cf. also *Big Wolf Corp.* v. *Commissioner,* 2 T. C. 751, in which the whole Tax Court without dissent decided that the average cost rule was proper even for determining the cost of new shares exchanged for old shares in the same corporation in a recapitalization on the theory that the old shares lost their identity when traded for the new shares and that identification was not possible.

In the present case the only evidence offered for the purpose of establishing identification between the old shares and the new shares was Paragraph X of the stipulation (R. 22) relating to the matching of certificate numbers. As has been shown, even though certificate numbers were matched against each other, the matching, unless shown to rest on a factual basis of identity, would be without legal significance to identify shares. The stipulation fails, however, to show even that there was an intent to identify particular shares with particular shares through the device of matching certificates.

In the case of the preferred stock exchange the stipulation shows only that the whole block of 865 Great Western preferred shares represented by 9 certificates was surrendered all at one time and 162$\frac{3}{16}$ shares of Dow common represented by three certificates were issued in lieu thereof. Not only, therefore, is evidence lacking of an intent to identify shares by matching numbers in the case of the preferred stock exchange, but there is even no proof that a particular certificate of Dow was issued in lieu of, or matched with, any particular certificate or certificates of Great Western preferred. From this group 162 shares of Dow stock represented by two certificates were sold in 1940 (R. 22), but it is not possible to ascertain exactly against which preferred stock certificates those Dow certificates were issued. Consequently none of the Dow shares sold in 1940 have been identified with any particular Great Western preferred shares, even through the arbitrary method of matching certificates.

Nor was there identification in the case of the common stock exchange. Although the stipulation shows that two 100-share certificates in Dow were issued by the transfer agent in lieu of two 100-share certificates of Great Western, and a 50-share certificate in Dow in lieu of two Great Western certificates representing a total of 50 shares (R. 22), this particular alignment of certificates was manifestly due, not to design, but to the fact that the same numbers of shares were being exchanged. The issuance of new certificates in 100-share denominations in lieu of the old shares in that denomination conformed to custom and convenience and was not the result of any intent, so far as the stipulation shows, to identify certain shares with certain shares through matching certificates. Thus the matching of certificates is without significance for identification purposes. But even if it could be construed as an effort by the transfer agent actually to identify the shares by certificate numbers, the stipulation fails to show what criteria guided it. Since every share of Dow was like every other share, it is apparent that the only criteria the agent could have used would have been purely arbitrary. We submit that the mere alignment of certain certificates, without some evidence, first, of an intent to identify shares through matching certificate numbers, and second, of real identification between the shares resting on some factual basis, is not sufficient to identiy any new share with any old share.[9]

But even if it be assumed *arguendo* that the arbitrary matching of certificates in the case of the exchange of Great Western common stock for Dow stock was sufficient identification, only 50 of the 212 shares sold in 1940 were received in 1939 in lieu of old common stock. The remaining 162 shares sold in 1940 have not been identified with particular old preferred shares. Thus, although the cost to taxpayer of the 50 shares may be determinable, assuming there was identification, by reference to the cost of the old common shares with which they were identified, the

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[9] The Tax Court stated (R. 47)—

The shares of Dow sold by the petitioners in 1940 are traceable through stock certificate numbers to specific shares of Great Western which were turned in in exchange

We do not construe this as a finding that there was identification in a legal sense of the old shares with the new, but if it should be interpreted as a finding that there was identification, we dispute its accuracy. The only evidence before the Tax Court relating to identification was Paragraphs X and XI of the stipulation (R. 22) and the Tax Court's statement must necessarily be based upon those paragraphs. The inferences to be drawn from the stipulation have been discussed above and they do not sustain the Tax Court's statement.

cost of the 162 shares can not be determined by reference to any particular old preferred shares. The basis for the 162 shares must therefore be determined in any event by averaging the cost of all old preferred shares over the Dow shares received in lieu thereof. And we submit that in the absence of complete identification of all the shares, the average cost method should be used to determine the basis of all the stock acquired in one exchange, rather than a hybrid system of one method for part of the stock and another method for the balance.[10]

It could not be fairly asserted in this case that identification has been made on the basis of showing identity or similarity of the old and new shares. There is unequivocal evidence that the shares in the new company were not the same as the old shares. The new share represents a proportional interest in a different corporation with different assets than did the old share. The old Great Western common and preferred shares represented an interest in a California corporation which manufactured products from salt and soda concentrates by electro-chemical processes. (R. 21.) The shares of Dow represented interests in a corporate enterprise which produced

[10] The Tax Court stated (R. 47) that the cost to taxpayer of the Great Western shares represented by the 212 shares of Dow stock sold by her was $13,900.17. This figure is not contained in the stipulation and can only have been computed by the hybrid system indicated above, of using actual cost for the Great Western common shares represented by 50 Dow shares, and computing the cost of 162 of the shares sold by averaging the cost of all the Great Western preferred shares over all the Dow shares received in lieu thereof.

heavy, intermediate, industrial, pharmaceutical, and aromatic chemicals, solvents, dyes, insecticides, metals, and alloys, and also continued the business formerly carried on by Great Western. (R. 21.) Consequently the proportionate interest in the corporate assets represented by particular share of Great Western stock, either common or preferred, was not identical or even related, so far as the record shows, with the interest represented by a Dow share after the merger, nor was the value of the old and new shares shown to be identical or even approximately the same. Cf. *Helvering* v. *Stifel, supra.* In view of these facts, there is no merit to the taxpayer's contention (Br. 21) that identity existed between the old and new shares because the identity of the old corporation somehow persisted or continued in the new corporation. Even if it could be said that the old corporation continued, which we dispute, its shares ceased to exist and were not replaced by new shares which were identical or similar.

Taxpayer contends (Br. 15–17) that each new share has been identified with a corresponding old share by operation of law by reason of the fact that on the date of the merger each share of Great Western was separately exchanged for a Dow share or fraction thereof. It has already been shown that the exchange was not share for share but that taxpayer's entire stock interest in the old corporation was exchanged for an interest in the new in one transaction. But even if it be assumed *arguendo* that the taxpayer correctly contends that the exchange was completed by operation of law on a share for share basis on the date the merger became effective, there has been no identification of particular old shares with any of the new shares sold in 1940. It can be said under this theory that each old share was exchanged for a new share or fraction thereof, but it is impossible to say which old share was exchanged for which new share. By disregarding the exchange of certificates in 1939 and relying only on the intangible exchange of stock interests which took place upon the merger, the taxpayer has also eliminated the one possible means available to her upon this record, that is, the matching up of stock certificates, for identifying the shares sold in 1940 as having been exchanged for any particular block or blocks of old stock. Consequently, under taxpayer's own theory it is impossible to determine the cost basis of any new share sold by identifying that share with a particular old share, and she is relegated to the average method of determining cost of the shares sold in 1940.

Taxpayer also argues (Br. 19–22) that identity of the old stock with the new is established in her case by operation of law equally as in the *Kraus* and *Fuller* cases. Those cases involved the problem of identifying old and new shares in the same corporation, whereas the instant case presents the problem of identifying the shares of one corporation with those of another. Assuming that this difference is immaterial, however, the test of identity prescribed in those cases was identification of a specific old share or shares with a specific new share or shares by means of evidence, and in neither case was it held that identity was established by operation of law. The instant case fails to meet that test; here there was no identification of specific shares by any method.

CONCLUSION

The decision of the Tax Court should be affirmed.

Respectfully submitted.

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